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PAGE 01 BONN 14550 01 OF 06 052017Z

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DEPARTMENT PASS TREASURY AND FEDERAL RESERVE

E.O. 11652: N/A

TAGS: EFIN, GW

SUBJECT: THE GERMAN EXPORT INDUSTRY REVISITED

REF.: BONN A-479 SEPTEMBER 20, 1974

1. SUMMARY. MUCH OF GERMANY'S CAPITAL GOODS INDUSTRY -
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PAGE 02 BONN 14550 01 OF 06 052017Z

THE MAJOR EXPORT ORIENTED SECTOR - EXPANDED DURING A

PERIOD OF DM UNDERVALUATION AND WAS AIDED DURING 1973 AND 1974 BY AVAILABLE INDUSTRIAL PRODUCTIVE CAPACITY IN GERMANY DUE TO SLACK DOMESTIC DEMAND AND BY SIGNIFICANTLY VARIED INFLATION RATES ABROAD. FACED WITH THE POSSIBILITY OF LOWER INFLATION ABROAD THAN IN THE RECENT PAST AND A MARKET-DETERMINED DM EXCHANGE RATE, GERMAN INDUSTRY WILL BE CONFRONTED BY A MORE COMPETITIVE FIELD OVERSEAS.

2. EITHER IN REACTION TO OR AS A CONSEQUENCE OF THESE DEVELOPMENTS, GERMANY'S EXPORT INDUSTRY WILL LIKELY UNDERGO BOTH DIRECTIONAL AND STRUCTURAL ADJUSTMENTS. THE RESULT WILL BE A TAPERING IN THE NATION'S TRADE SURPLUS AND CURRENT ACCOUNT. EXPORT SURPLUSES WITH WESTERN INDUSTRIAL NATIONS WILL DROP MARKEDLY. GERMAN EXPORTS TO OPEC MEMBERS, WHICH HAVE GROWN SIGNIFICANTLY IN THE LAST TWO YEARS, WILL CONTINUE TO GROW. EXPORTS TO THE STATE TRADING NATIONS, WHICH HAVE DOUBLED IN THE LAST THREE YEARS, WILL GROW FURTHER BUT ARE LIKELY TO PLATEAU IN NEAR TERM FUTURE. BOTH EXPORTS TO AND IMPORTS FROM THE DEVELOPING NATIONS WILL INCREASE BEYOND THE CURRENT 20 AND 25 PERCENT, RESPECTIVELY, OF TOTAL GERMAN EXPORTS AND IMPORTS. FAR LESS CONSPICUOUS BUT MORE FAR-REACHING ARE FACTORS POINTING TO STRUCTURAL CHANGES IN GERMAN INDUSTRY. IT IS LIKELY THAT DESPITE GERMANY'S UNEMPLOYMENT RATE AND DUE PRINCIPALLY TO RELATIVELY HIGH LABOR AND SOCIAL COSTS A CONSIDERABLE AMOUNT OF THE NATION'S REMAINING LABOR INTENSIVE INDUSTRY WILL BE LOST TO DEVELOPING NATIONS. GERMAN INVESTMENTS ABROAD WILL LIKELY GROW SHARPLY IN THE NEXT SEVERAL YEARS, ESPECIALLY IN THE INDUSTRIALIZED NATIONS. AS GERMAN FOREIGN INVESTMENT INCREASES, THERE WILL BE A SHIFT IN A SIGNIFICANT FACTOR IN THE NATION'S EXPORT SURPLUS, NAMELY THE RATIO BETWEEN DELIVERIES TO FOREIGN CUSTOMERS DIRECTLY FROM GERMANY AND DELIVERIES FROM FOREIGN SUBSIDIARIES. END SUMMARY.

3. THE ONGOING RECESSION AND EXPECTED CONSEQUENCES OF THE ENERGY AND RAW MATERIAL CRISIS HAVE CONCENTRATED GERMAN ATTENTION ON THE OUTLOOK FOR THE FUTURE OF THE LIMITED OFFICIAL USE

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PAGE 03 BONN 14550 01 OF 06 052017Z

NATION'S EXPORT INDUSTRIES. CHANGES BOTH OF A DIRECTIONAL AND STRUCTURAL NATURE ARE EXPECTED.

4. IN MAY GERMANY'S EXPORTS WERE DOWN 17 PERCENT AGAINST MAY 1974 WHILE IMPORTS WERE DOWN 11 PERCENT COMPARED WITH THE SAME MONTH OF 1974. WHILE THE JUNE FIGURES SHOWED A SLIGHT IMPROVEMENT, THE 1975 FIRST-HALF TRADE SURPLUS FELL TO DM 19.7 BILLION FROM DM 25.3 BILLION IN

THE SAME PERIOD OF 1974. IN REAL TERMS THE FIRST SIX MONTHS OF 1975 PRODUCED A 13 PERCENT DROP IN EXPORTS WHILE IMPORTS INCREASED SLIGHTLY BY 2 PERCENT. AN ANALYSIS OF THE EXPORT/IMPORT BALANCES BY COUNTRY AND GROUPS OF COUNTRIES SUPPORTS THE ARGUMENT THAT THE LOWER TRADE SURPLUS OF GERMANY THIS YEAR IS DUE CHIEFLY TO THE RECESSION IN THE WEST. IN THE FIRST SIX MONTHS OF 1975 THE EXPORT SURPLUS WITH INDUSTRIAL COUNTRIES TOPPLED TO DM 11.2 BILLION FROM DM 23.8 BILLION IN THE SAME PERIOD IN 1974. DURING THE 1975-77 PERIOD THERE WILL BE LOWER TRADE SURPLUSES, AS DISCUSSED BELOW, BUT THEY WILL NOT BE ATTRIBUTABLE TO MULTI-COUNTRY RECESSION. SHOWING A CONTRARY TREND THE EXPORT BALANCE WITH DEVELOPING NATIONS JUMPED TO A SURPLUS OF DM 3.8 BILLION FROM A DEFICIT OF DM 1.7 BILLION IN THE SAME TIME PERIODS. TABLE I BELOW

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PAGE 01 BONN 14550 02 OF 06 052021Z

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SHOWS THE TRADE PATTERNS WITH VARIOUS COUNTRY GROUPS
 DURING THE PAST 3-1/2 YEARS.

TABLE I
 TRADE BALANCES (DM BILLIONS)
 (DIFFERENCES DUE TO ROUNDING)
 (IMPORTS CIF, EXPORTS FOB)
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PAGE 02 BONN 14550 02 OF 06 052021Z

LST HALF
 1972 1973 1974 1975
 --- --- --- ---

ALL COUNTRIES

EXPORTS	149.0	178.4	230.6	108.4
IMPORTS	128.7	145.4	179.7	88.8
BALANCE	20.3	33.0	50.8	19.7

INDUSTRIAL NATIONS

EXPORTS	116.2	137.2	168.9	75.4
IMPORTS	99.1	109.2	125.0	64.2
BALANCE	17.1	28.0	43.9	11.2

EEC MEMBER COUNTRIES

EXPORTS	69.9	84.1	103.5	47.3
IMPORTS	69.1	75.5	86.2	44.3
BALANCE	.8	8.5	17.3	3.0

DEVELOPING NATIONS

EXPORTS	24.9	30.0	45.1	24.3
IMPORTS	24.2	29.5	46.1	20.5
BALANCE	.7	.5	-1.1	3.8

OPEC COUNTRIES

EXPORTS	4.7	5.9	10.2	7.4
IMPORTS	8.3	10.1	23.0	9.0
BALANCE	-3.6	-4.2	-12.8	-1.6

STATE TRADING COUNTRIES

EXPORTS	7.7	10.8	15.9	8.4
IMPORTS	5.3	6.6	8.4	3.9
BALANCE	2.3	4.2	7.5	4.5

5. SOME GERMAN ECONOMIC FORECASTERS, INCLUDING THE RESPECTED IFO RESEARCH INSTITUTE, ARGUE THAT THE VALLEY IN THE NATION'S EXPORT DECLINE HAS BEEN REACHED AND, AS THE ECONOMIES IN WESTERN EUROPE AND THE USA IMPROVE, SO WILL THE VOLUME OF GERMAN EXPORTS. HOWEVER, GERMANY'S EXPORT TRADE IS FOR THE MOST PART CONCENTRATED LIMITED OFFICIAL USE

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PAGE 03 BONN 14550 02 OF 06 052021Z

IN CAPITAL INTENSIVE INDUSTRIES FOR WHOSE PRODUCTS WORLD DEMAND WAS PARTICULARLY STRONG DURING THE INVESTMENT INTENSIVE LATE 1972 TO EARLY 1974 PERIOD. IT WAS PRECISELY THESE INDUSTRIES WHICH WERE ABLE TO DELIVER EASILY THEIR PRODUCTS -- ESPECIALLY SPECIALIZED ORDERS FOR WHICH THERE WAS RELATIVELY LITTLE PRICE ELASTICITY. A CONSIDERABLE VOLUME OF THESE EXPORTS WERE BEING DELIVERED ABROAD WHEN THE ECONOMIES OF GERMANY'S TRADING PARTNERS WERE WELL HEATED AND POSSESSED LITTLE EXCESS INDUSTRIAL CAPACITY TO SATISFY DOMESTIC DEMAND. GERMANY HAD NO DIFFICULTY FULFILLING THE DEMAND DUE TO ITS SLUGGISH INTERNAL ECONOMY. THIS UNIQUE SET OF CIRCUMSTANCES PROBABLY WILL NOT BE DUPLICATED AS THE WEST CLIMBS FROM THE CURRENT RECESSION.

6. TABLE II SHOWS THE DEVELOPMENT OF IMPORTS AND EXPORTS BY VOLUME (SEASONALLY ADJUSTED, 1970 PRICES) FROM 1972 THROUGH FIRST HALF 1975. COMPARING THE FIRST QUARTER FIGURES OF 1972 AND 1974, EXPORTS WERE UP DM 13.5 BILLION WHILE IMPORTS WERE UP ONLY DM 1.9 BILLION. THE FIRST QUARTER 1974 TRADE SURPLUS WAS 5.5 TIMES THE FIRST QUARTER 1972 SURPLUS. THEREAFTER THE MULTIPLE BEGAN TO FALL -- TO 2.4 BY THE SECOND QUARTER OF 1975.

TABLE II

	1ST	2ND	3RD	4TH
	----	----	----	----
1972				

EXPORTS	34.4	35.2	35.6	39.3
IMPORTS	31.9	33.2	33.5	35.2
BALANCE	2.6	2.0	2.1	4.1

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PAGE 01 BONN 14550 03 OF 06 052027Z

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LIMITED OFFICIAL USE SECTION 03 OF 06 BONN 14550

1973

EXPORTS	39.7	41.0	43.0	43.7
IMPORTS	35.6	35.3	34.9	35.9
BALANCE	4.1	5.7	8.0	7.8

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PAGE 02 BONN 14550 03 OF 06 052027Z

1974

EXPORTS	47.9	47.2	47.5	46.0
IMPORTS	33.8	35.0	36.0	35.6
BALANCE	14.1	12.2	11.7	10.4

1975

EXPORTS	41.3	41.8
IMPORTS	34.3	35.5
BALANCE	7.0	6.2

7. THE INTENSITY AND SERIOUSNESS WITH WHICH WESTERN POLITICAL LEADERS ARE NOW APPROACHING COMMITMENTS TOWARD ECONOMIC POLICY HARMONIZATION MAY POINT TO A GREATER DEGREE OF COORDINATION IN THE DESIGN OF DOMESTIC STIMULATIVE PROGRAMS. WHILE THE MAGNITUDE AND IMPACT OF SUCH PROGRAMS WILL VARY, A FORESEEABLE RESULT WILL PROBABLY BE A GENERAL REDUCTION IN TRADE DISTORTIONS CAUSED BY NON-PARALLEL DOMESTIC BUSINESS CYCLES AND, IN THE MAJOR INDUSTRIAL NATIONS AT LEAST, THE VARIATIONS IN COUNTRY TO COUNTRY INFLATION RATES. SINCE THESE FACTORS IN THE PAST HAD CLEARLY CONTRIBUTED TO EXTERNAL DEMAND, SUCH A DEVELOPMENT PORTENDS A MUCH MORE COMPETITIVE OVERSEAS MARKET FOR GERMAN GOODS.

8. ALTHOUGH IT IS MORE PROBABLY THE RESULT OF THE SHARP DOWNTURN IN FOREIGN ORDERS FROM EC NEIGHBORS RATHER THAN A CALCULATED ANTICIPATION OF A FUTURE ATMOSPHERE IN WHICH THEIR PROSPECTS WOULD BE LESS PRICE COMPETITIVE, GERMAN EXPORTERS HAVE JUMPED QUICKLY TO SATISFY THE HUNGER FOR DEVELOPMENT IN THE OPEC COUNTRIES AND THE THIRD WORLD AND THEREBY SPREAD THE REPUTATION, DELIVERY CAPACITIES AND SERVICE RECORD OF GERMAN INDUSTRIES. THESE LAST THREE FACTORS ARE NOT UNIMPORTANT IN PRESERVING SIZABLE, DEPENDABLE MARKETS. IN THE FIRST SIX MONTHS OF 1975 THE TRADE SURPLUS WITH THE DEVELOPING NATIONS WAS JUST OVER A THIRD THE SURPLUS WITH THE INDUSTRIALIZED NATIONS, A

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PAGE 03 BONN 14550 03 OF 06 052027Z

TREMENDOUS CLIMB FROM THE SIZABLE DEFICIT IN TRADE WITH THIS COUNTRY GROUP DURING 1974. THE JANUARY/JUNE 1975

TRADE DEFICIT WITH OPEC COUNTRIES WAS ONLY DM 1.6 BILLION, COMPARED WITH A DEFICIT OF DM 7.0 BILLION DURING THIS PERIOD LAST YEAR. TABLE III BELOW SHOWS THE TRADE PATTERNS WITH THE DEVELOPING NATIONS (INCLUDING OPEC) DURING THE LAST SIX QUARTERS.

TABLE III
TRADE WITH DEVELOPING NATIONS
(INCLUDING OPEC)
DM BILLIONS

	1974				1975	
	1ST QTR	2ND QTR	3RD QTR	4TH QTR	1ST QTR	2ND QTR
EXPORTS	9.6	10.7	11.4	13.3	11.7	12.6
IMPORTS	10.8	11.3	12.1	12.0	9.9	10.6
BALANCE	-1.1	-.59	-.65	1.3	1.8	2.0

9. ALTHOUGH LOGIC ARGUES FOR A NOT-TOO-DISTANT SATURATION POINT FOR EXPORTS TO OPEC COUNTRIES, THE FRG IS FEVERISHLY JOINING WITH MANY OF THESE NATIONS IN THE CREATION OF SPECIAL BILATERAL INDUSTRIAL AND TRADE COMMISSIONS WITH THE CLEAR PURPOSE OF ASSURING ACCESS TO OPEC OIL THROUGH A PROMISE OF GERMAN TECHNOLOGY AND MANAGEMENT KNOWHOW. THE DEVELOPMENT PLANS IN CERTAIN OPEC NATIONS - NOTABLY IRAN AND SAUDI ARABIA - POINT TO ENORMOUS EXTERNAL DEMAND DURING THE NEXT FEW YEARS. THIS DEMAND WILL BE PARTICULARLY STRONG IN THE CAPITAL GOODS AREA. FUTURE BILATERAL AGREEMENTS WITH INDIVIDUAL OPEC COUNTRIES WILL ALSO COMMIT GERMAN INDUSTRY TO LARGE CAPITAL INVESTMENTS WITHIN THESE COUNTRIES. TO THE EXTENT THAT SUCH GERMAN INVESTMENTS ARE USED TO SUPPLY

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PAGE 01 BONN 14550 04 OF 06 052047Z

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LIMITED OFFICIAL USE SECTION 04 OF 06 BONN 14550

THIRD COUNTRY DEMAND FOR GOODS PREVIOUSLY PRODUCED IN GERMANY, THE NATION'S TRADE SURPLUS WILL BE LOWERED. SUCH INDUSTRIAL EXPANSION ALSO OPENS MARKETS FOR OTHER GERMAN EXPORTS.

10. THE TRADE SURPLUS WITH THE STATE CONTROLLED ECONOMES HAS ALSO JUMPED SIGNIFICANTLY FROM DM 2.9
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PAGE 02 BONN 14550 04 OF 06 052047Z

BILLION IN THE FIRST SIX MONTHS OF 1974 TO DM 4.5 BILLION IN THE SAME PERIOD THIS YEAR. THE GENERAL EASING IN TENSIONS BETWEEN EAST AND WEST WILL ENCOURAGE AN EXPANSION OF TRADE WITH EASTERN EUROPE, BUT THE OVER-ALL IMPORTANCE OF SUCH TRADE IN COMPARISON WITH TOTAL TRADE WILL REMAIN MINOR. WHILE THE ATMOSPHERE FOR INCREASED TRADE EXISTS, THE REALITY OF THE WEAK BALANCE OF PAYMENTS POSITION OF MOST EAST EUROPEAN STATES MIGHT WELL PRECLUDE ANY SIZABLE INCREASE IN DEMAND BEYOND PRESENT LEVELS.

11. BASED ON THE ASSUMPTION THAT THOSE FACTORS CONTRIB-

UTING TO GERMANY'S TRADE SURPLUS DURING THE LAST THREE YEARS WILL BE MODIFIED THROUGH INCREASED DOMESTIC PRODUCTIVE CAPACITY IN OTHER COUNTRIES AND IMPROVED COMPETITIVE POSITION OF GERMANY'S MAJOR TRADING PARTNERS, BROAD BUT REALISTIC FORECASTS OF TRADE LEVELS IN THE MEDIUM TERM FUTURE ARE POSSIBLE. THESE FORECASTS ARE SHOWN IN TABLE IV:

TABLE IV
FORECAST OF TRADE SURPLUS
DM BILLIONS, CURRENT PRICES

	1975	1976	1977
EXPORTS (FOB)	219.0	236.5	264.8
IMPORTS (CIF)	177.4	205.9	238.0
BALANCE	41.6	30.6	26.8

12. DURING THE REMAINDER OF 1975 WE ASSUME THAT EXPORTS WILL AT BEST INCREASE SLIGHTLY (2 PERCENT) OVER THE FIRST HALF FIGURES WHILE IMPORTS WILL STAGNATE AT THE JANUARY TO JUNE LEVEL. FOR 1976 THE INCREASE IN EXPORTS TO THE LDC'S OPEC AND THE STATE TRADING NATIONS, WE FORECAST, WILL PARTLY COMPENSATE FOR RELATIVELY LOWER WESTERN EUROPEAN DEMAND FOR GERMAN GOODS. ASSUMING THAT IN 1976 GERMAN EXPORTS WILL BE GETTING OUT OF THE CYCLICAL SLUMP OF 1975 WE FORESEE AN APPROXIMATE 8 PERCENT GROWTH IN EXPORTS FROM 1975 TO 1976. THE EXPECTED RECOVERY OF THE GERMAN ECONOMY, PRESUMABLY LIMITED OFFICIAL USE

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PAGE 03 BONN 14550 04 OF 06 052047Z

IN UPSWING BY 1976, WILL GENERATE A SIGNIFICANT DEMAND FOR PRICE COMPETITIVE FOREIGN GOODS. OPTIMISTICALLY ASSUMING A GROWTH OF 1975 GNP (IN MARKET PRICES) TO DM 1045 BILLION UP 4.5 PERCENT FROM 1974 AND A FURTHER 9.5 PERCENT GROWTH IN 1976 TO DM 1144 BILLION AND A MODERATE INCREASE IN IMPORTS AS A PERCENT OF GNP TO 18 PERCENT (IT INCREASED FROM 16 PERCENT TO 18 PERCENT BETWEEN 1970 AND 1974 BUT WILL PROBABLY BE AT ABOUT 17 PERCENT FOR 1975), THE EXPORT SURPLUS COULD FALL TO DM 30.6 BILLION IN 1976. 1977, BY OUR CALCULATIONS, WILL BRING A FURTHER DROP FROM 1976 IN THE GERMAN TRADE SURPLUS. DURING 1977 WE EXPECT GNP TO GROW AT APPROXIMATELY THE 1972-75 LEVEL, I.E., AROUND 9.5 PERCENT PER YEAR, TO DM 1252.7 BILLION. ASSUMING AN INCREASE IN EXPORTS OF 12 PERCENT (THE 1970-3 AVERAGE) AND IMPORTS EXPRESSED AS A PERCENTAGE OF GNP TO 19 PERCENT, THE EXPORT SURPLUS COULD FALL TO DM 26.8 BILLION.

13. THE FORECASTS ABOVE ARE VERY TENTATIVE SINCE THEY ARE CALCULATED ON THE ASSUMPTION THAT FUTURE OIL IMPORT PRICE INCREASES, WHICH ARE IMPOSSIBLE TO PREDICT, ARE PARTLY SUBSUMED IN THE FORECASTS OF INCREASES OF IMPORTS AS A PERCENTAGE OF GNP, MAJOR OIL PRICE INCREASES COULD, OF COURSE, RESULT IN SIGNIFICANTLY LOWER TRADE SURPLUS THAN THOSE FORECASTED.

14. AN ADDITIONAL FACTOR TO BE BORNE IN MIND REGARDING THE TRADE SURPLUS IS THE EFFECT OF THE CHANGING EXTERNAL VALUE OF THE DEUTSCHEMARK. THE INCREASE AGAINST ALL CURRENCIES (IN RELATION TO CENTRAL RATES AT THE END OF 1972) HOVERED BETWEEN 20 AND 22.5 PERCENT DURING THE FIRST TWO MONTHS OF 1975. SINCE THAT TIME THE PERCENTAGE HOWEVER HAS FALLEN TO CLOSE TO 15. A CONTINUATION OF THIS DEVELOPMENT, ASSUMING AN INCREASE IN IMPORTS IN VOLUME TERMS, WILL LEAD TO HIGHER

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PAGE 01 BONN 14550 05 OF 06 052104Z

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LIMITED OFFICIAL USE SECTION 05 OF 06 BONN 14550

IMPORT COSTS AND A FURTHER LOWERING OF THE TRADE SURPLUS

15. WHILE GERMANY'S JUMP IN EXPORT SURPLUS FROM 1973 TO 1974 WAS DUE TO THE PRONOUNCED DIFFERENCES IN BUSINESS ACTIVITIES AND INFLATION RATES BETWEEN GERMANY AND ITS MOST IMPORTANT TRADING PARTNERS -- DIFFERENCES THAT WILL NOT PERSIST, OTHER FACTORS WHICH UNDER MORE NOR-LIMITED OFFICIAL USE

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PAGE 02 BONN 14550 05 OF 06 052104Z

MAL TIMES HEAVILY INFLUENCE THE FLOW OF INVESTMENT AND CAPITAL DO PERSIST. OF PARTICULAR IMPORTANCE IS THE COST OF LABOR AND THE ASSOCIATED SOCIAL COSTS WHICH IN GERMANY HAVE JUMPED OVER 30 PERCENT IN THE LAST THREE YEARS. THE RISE IN UNIT LABOR COSTS WILL HAVE AN INCREASINGLY DAMPENING EFFECT ON GERMAN EXPORTS. THE EFFECT COULD BE ACCENTUATED AS POTENTIAL COMPETITORS OF GERMANY EXPORTERS IN OTHER INDUSTRIALIZED NATIONS, SIMILARLY AFFECTED BY LABOR COSTS, INCREASE THEIR INVESTMENTS ABROAD IN ORDER TO EXPLOIT THE LESS EXPENSIVE LABOR MARKETS IN THE DEVELOPING NATIONS. PARTICULARLY SUSCEPTIBLE TO THESE DEVELOPMENTS WILL BE SUCH LABOR INTENSIVE, EXPORT-ORIENTED GERMAN INDUSTRIES AS SHOE AND LEATHER PRODUCTS, WOOD AND WOOD PROCESSING, AND TEXTILES, WHICH TOGETHER CONTRIBUTED 8.6 PERCENT OF THE PRODUCTION VOLUME OF GERMAN INDUSTRY IN 1972, THE LAST YEAR FOR WHICH STRUCTURAL COMPARISONS ARE AVAILABLE.

16. OUTFLOWS OF GERMAN INVESTMENT TO LDC'S DURING 1974 AMOUNTED TO ABOUT 25 PERCENT OF TOTAL OUTFLOWS DURING THE YEAR. WHILE IT IS IMPOSSIBLE TO ISOLATE THE INVESTMENTS WHICH REPRESENTED OUTFLOWS DUE TO LABOR COSTS IN GERMANY, SUCH COSTS ALONG WITH THE EXCHANGE RATE ELEMENT WHICH HAS ADDED TO THE OVERSEAS COSTS OF GERMAN PRODUCTS AND BILATERAL AGREEMENTS BETWEEN THE FRG AND VARIOUS LDC'S TO SECURE LONG-RANGE SUPPLIES OF NEEDED RAW MATERIALS FOR GERMAN INDUSTRIES IN EXCHANGE FOR GERMAN TECHNOLOGY HAVE INTERACTED TO

PRODUCE THIS INVESTMENT FLOW. HOWEVER, DUE TO SOCIAL AND POLITICAL UNREST IN MANY OTHERWISE LIKELY RECIPIENTS OF GERMAN INVESTMENT, INVESTMENT LEVELS WILL PROBABLY NOT GROW SIGNIFICANTLY ACROSS A BROAD FRONT TO DEVELOPING NATIONS BUT RATHER WILL TEND TO CONCENTRATE IN BRAZIL, SPAIN, AND, AS PREVIOUSLY MENTIONED, CERTAIN OPEC NATIONS.

17. GERMAN INDUSTRIALISTS HAVE LONG RECOGNIZED THAT THE DOMESTIC MARKET WOULD NOT ABSORB THE TOTAL OUTPUT OF MODERN PRODUCTION AND THEREFORE VIEWED THE EXPORT MARKET AS AN ECONOMIC AND COMMERCIAL NECESSITY. COUPLED LIMITED OFFICIAL USE

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PAGE 03 BONN 14550 05 OF 06 052104Z

WITH A FIXED EXCHANGE RATE SYSTEM WHICH CLEARLY PEGGED THE DM BELOW ITS ACTUAL VALUE, THIS ENCOURAGED LARGE SCALE DEVELOPMENT AND EXPANSION OF GERMANY'S EXPORT-ORIENTED INDUSTRIES. THE VULNERABILITY OF THIS EXPORT MENTALITY AND THE INDUSTRIAL STRUCTURE BUILT UP TO SATISFY IT WAS DEMONSTRATED AS THE WORLD WIDE ECONOMIC RECESSION SET IN. FOREIGN ORDERS IN JUNE HAD SLIPPED 16.0 PERCENT IN COMPARISON WITH THE SAME MONTH IN 1974, AND, WHILE SOMEWHAT BETTER THAN THE 22.2 PERCENT DROP IN MAY, REPRESENTS A CONTINUATION OF LOWER ORDERS EVIDENT IN EACH MONTH SINCE NOVEMBER OF LAST YEAR. THE JUNE JUMP IN DOMESTIC ORDERS WAS MOSTLY DUE TO LAST MINUTE ORDERS PLACED TO TAKE ADVANTAGE OF THE GOVERNMENT'S INVESTMENT BONUS THAT EXPIRED AT THE END OF JUNE. THE DOWNWARD TREND IN FOREIGN ORDERS IS SHOWN IN TABLE V BELOW:

TABLE V
TRENDS IN DOMESTIC AND FOREIGN ORDERS
(AS PER CENT CHANGE FROM PREVIOUS YEAR)

	1974				
	AUG	SEP	OCT	NOV	DEC
DOMESTIC	3.6	6.4	6.4	-0.5	1.8
FOREIGN	36.7	16.8	25.2	6.7	-7.3

	1975			
	JAN	FEB	MAR	APR
DOMESTIC	1.2	-4.1	-9.7	3.8
FOREIGN	-10.0	-9.2	-23.8	-15.7

	1975		
	MAY	JUN	JUL

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PAGE 01 BONN 14550 06 OF 06 052109Z

65

ACTION EUR-12

INFO OCT-01 EA-07 ISO-00 FEA-01 AGR-05 CEA-01 CIAE-00

COME-00 DODE-00 EB-07 FRB-03 H-02 INR-07 INT-05 L-03

LAB-04 NSAE-00 NSC-05 PA-01 AID-05 CIEP-01 SS-15

STR-04 TAR-01 TRSE-00 USIA-06 PRS-01 SP-02 OMB-01

XMB-02 OPIC-03 ERDA-05 FPC-01 PM-04 SAM-01 OES-03

IO-10 SIL-01 /130 W

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R 051953Z SEP 75

FM AMEMBASSY BONN

TO SECSTATE WASHDC 2672

INFO AMEMBASSY BRUSSELS

AMEMBASSY COPENHAGEN

AMEMBASSY DUBLIN

AMEMBASSY THE HAGUE

AMEMBASSY LONDON

AMEMBASSY LUXEMBOURG

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

USMISSION OECD PARIS

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DOMESTIC -14.2 36.1 1.4

FOREIGN -22.2 -16.0 -16.9

18. PRESENTLY GERMANY HAS RELATIVELY MEAGER FOREIGN
DIRECT INVESTMENTS COMPARED TO OTHER INDUSTRIALIZED

COUNTRIES. GERMAN DIRECT INVESTMENTS ABROAD, ACCORDING
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PAGE 02 BONN 14550 06 OF 06 052109Z

TO THE MOST RECENT STATISTICS, AMOUNT TO ABOUT 3.5 PERCENT OF THE NATION'S GNP -- COMPARED WITH ALMOST 30 PERCENT FOR SWITZERLAND, 17 PERCENT FOR GREAT BRITAIN, 10 PERCENT FOR BELGIUM, NETHERLANDS AND SWEDEN, 8 PERCENT FOR THE USA, 6.5 PERCENT FOR CANADA AND 6 PERCENT FOR FRANCE. FOR REASONS OF MARKET PRESERVATION AND IN ORDER TO REDUCE THE VULNERABILITY OF THE DOMESTIC ECONOMY TO EXTERNAL INFLUENCES, GERMAN INDUSTRY WILL INCREASINGLY EXPAND ITS INVESTMENTS ABROAD. SINCE A LARGE PERCENTAGE OF GERMANY'S FOREIGN CUSTOMERS RECEIVE DELIVERIES DIRECTLY FROM GERMANY AS OPPOSED TO SUBSIDIARIES OR AFFILIATES ABROAD, AN INCREASE IN FOREIGN INVESTMENT BY GERMAN INDUSTRIES WILL SIGNAL DECREASES IN GERMANY'S TRADE AND CURRENT ACCOUNT SURPLUSES.

19. THE DOMESTIC CONCERN OF THIS DEVELOPMENT IS THAT INCREASED FOREIGN INVESTMENT WILL BE INTERPRETED BY LABOR UNIONS AS AN EXPORT OF JOBS, AN ACCUTELY SENSITIVE MATTER WHEN, AS AT PRESENT, GERMANY'S UNEMPLOYMENT IS SO HIGH. THE GERMAN GOVERNMENT IS APPARENTLY WELL AWARE OF BOTH THE INEVITABILITY OF FURTHER INVESTMENT ABROAD AND THE LABOR UNION FEARS BUT IS UNLIKELY TO STIMULATE THE ECONOMY IN SUCH A MANNER AS TO REDUCE UNEMPLOYMENT THROUGH A BROAD, INDUSTRY-WIDE PROGRAM. THE GOVERNMENT SENSES THAT IN THE FACE OF A CHANGED EXTERNAL SITUATION WHERE GERMAN EXPORTS MIGHT BE LESS COMPETITIVE A LARGE STIMULATIVE EFFORT WOULD GENERATE DOMESTIC INVESTMENT IN THOSE CAPITAL- AND TECHNOLOGY-HEAVY SECTORS WHICH CAN PRESENTLY SATISFY FORESEEABLE DOMESTIC AND FOREIGN DEMAND. TO DO OTHERWISE WOULD ONLY EXACERBATE THE UNEMPLOYMENT PROBLEM AT A LATER TIME AND THEREBY CREATE EVEN MORE SOCIAL PROBLEMS. HENCE, AS ALL INDICATIONS FOR THE PAST SEVERAL WEEKS HAVE FOCUSED AND AS DECIDED BY THE CABINET THIS PAST WEEK, THE GOVERNMENT'S STIMULATIVE PROGRAM IS DESIGNED TO BEEF UP THE STAGGERING DOMESTIC CONSTRUCTION INDUSTRY WHERE THE MOST INTENSE UNEMPLOYMENT PROBLEMS EXIST AND WHERE ABSORPTION CAPACITY OF SEMI- AND UNSKILLED LABORERS IS THE GREATEST.

20. TO THE EXTENT THAT CONTINUED FOREIGN INVESTMENT BY
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PAGE 03 BONN 14550 06 OF 06 052109Z

GERMAN FIRMS AND/OR THE LOSS OF LABOR INTENSIVE INDUSTRIES TO THE LDC'S BEGAN TO SERIOUSLY INCREASE GERMANY'S UNEMPLOYMENT RATE, THE GOVERNMENT CAN BE EXPECTED TO INITIATE STIMULATIVE MEASURES TO PREVENT THE ISSUE FROM DOING GRAVE POLITICAL DAMAGE.

21. AGAINST THIS BACKGROUND WHICH HAS BRIEFLY REVIEWED CERTAIN REASONS FOR THE DOMESTIC GROWTH OF GERMANY'S EXPORT INDUSTRY AND PROBABLY FUTURE ADJUSTMENTS STANDS THE ADMITTEDLY PESSIMISTIC VIEW OF THE FUTURE OF WESTERN ECONOMIC STRENGTH HARBORED BY FRG CHANCELLOR SCHMIDT. THE CHANCELLOR IS ACUTELY AWARE OF THE INTERDEPENDENCE OF NATIONAL ECONOMIES BOTH IN TRADE AND MONETARY FIELDS. DESPITE HIS VISIBLE AND VOCAL SUPPORT FOR INTERNATIONAL EFFORTS TO GENERATE IMPROVED ECONOMIC COOPERATION, HE IS FULLY AWARE OF THE CIRCUMSTANCES WHICH CREATED THE EXPANSION SWELL IN GERMAN INDUSTRY -- I.E., FIXED EXCHANGE RATES AND BUSINESS CYCLE DIFFERENTIALS. CONFIDENT THAT THE WEST MAY SUCCEED IN REDUCING THE LATTER, HE MAY NOT WISH TO PERMANENTLY SEPARATE HIMSELF FROM THE BENEFITS (TO GERMANY) OF THE FORMER. THIS MAY PROVIDE SOME INSIGHT INTO THE CHANCELLOR'S TENDENCY TO SUPPORT THE FRENCH PROPOSAL FOR A RETURN TO FIXED PARITIES.
HILLENBRAND

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